

MDS Moore Diversified Services, Inc.

*Serving Senior Living Clients For Over 37 Years
There Is No Substitute For Experience*

“You’ve Got Questions . . . We’ve Got Answers”

February, 2009

COST RECOVERY FOR CAMPUS IMPROVEMENTS

Creating a Financially Viable Improvement Plan

Last month’s newsletter addressed one of the most significant challenges of senior living today – the physical plant aging process. The problems that come with aging buildings are relentless and every year issues become more serious. The January newsletter addressed *what* needed to be accomplished. Now let’s discuss *how* to pay for these campus improvements.

Determining the Cost-Effectiveness of Capital Improvements

Some of your capital investments will require difficult value judgments to determine whether they are really worth the dollars you would have to commit. I like to use a quantitative approach that reduces the decision to the lowest common denominator. This decision process should be viewed from two perspectives:

- 1. How much will I have to raise monthly fees** in order to cover (i.e., break-even on) the added capital costs? (Assume the necessary funds were borrowed at market interest rates.)
- 2. How will the value of my community be enhanced** with the new capital improvement investment? Try to be very specific in your value assessment.

To answer the above questions, let’s look at the two major areas where improvements would be made:

- Individual living units
- Common areas

Improvements to Assisted and Individual Living Units

First, let's evaluate the cost recovery of investing money in your individual living units by determining how many *additional dollars* Mrs. Barker – an existing resident – will have to pay each month in order for you to break even on the additional debt service needed to fund those improvements. This analysis involves a four step common-sense process:

- 1. Dollars invested.** Determine the amount that will be invested to enhance each individual living unit. Let's use \$10,000 as an average per unit cost as an example.
- 2. Cost of capital.** Determine the interest rate to be paid on the newly borrowed funds. This could be approximately 7 to 8 percent for a for-profit, or as low as 5 to 6 percent for a not-for-profit community (after the current credit crisis).
- 3. Debt payment.** Determine the annual increase in debt (for both principal and interest payments). This figure includes the additional money needed to pay for the improvements to each *individual* unit.
- 4. Adjust for debt service coverage ratio (DSCR).** This ratio simply states that your friendly lender wants you to have about \$1.30 in available cash (after operating expenses) for every dollar you owe in debt payments.

A Real World Example

Let's assume a \$10,000 investment per unit financed at an 8 percent interest rate for 30 years and assuming a 1.30x debt service coverage ratio yields the following calculations:

- \$10,000 times a debt service *constant* of 8.81 percent. A debt service constant takes into consideration both interest rate (8%) loan amortization (30 years) to compute total principal and interest payments. That payment is **\$881 per year**

Now we need to increase that amount by 1.30 times or \$264 in order to satisfy our lenders' required cash safety margin. That yields a total annual debt service obligation per unit of approximately **\$1,145 per year**. If you already have a favorable debt service coverage ratio you may not have to include the \$264. That would lower your needed cost recovery requirements. Finally, let's determine what it will cost Mrs. Barker on a *monthly* basis. So, we will divide the \$1,145 per year by 12 months, yielding approximately **\$95 per month**.

By following the above steps, you can now judge whether the perceived value of those investments are worth the increase passed on to residents. It's likely that Mrs. Barker will already be paying a base monthly service fee of approximately \$3,400 per month for assisted living. So the \$10,000 investment will increase what she pays per month by \$95 or \$3.09 per resident-day; about a 3.0 percent increase in her monthly service fee.

Mrs. Barker might experience mild sticker shock, primarily due to habit, not necessarily affordability. However, a *new* prospect viewing an improved *vacant* unit might see considerable value and give a deposit without flinching at the price.

Note that \$10,000 can usually fund significant capital improvements for a single living unit. Figure 1 provides a matrix of different levels of *individual living unit* capital improvement investments vs. borrowed money interest rates.

FIGURE 1
COST RECOVERY FOR CAPITAL
INVESTMENT IMPROVEMENTS TO *INDIVIDUAL LIVING UNITS*

Individual Living Unit Capital Improvement	Break-Even Increase in Resident's Monthly Service Fee to Cover Incremental Increase in Debt Service on Borrowed/Invested Funds to Pay for Improvement¹				
	7.0%	7.5%	8.0%	8.5%	9.0%
\$ 3,000/unit	\$25.95	\$27.27	\$28.62	\$29.99	\$31.38
5,000	43.24	45.45	47.69	49.98	52.30
7,500	64.87	68.17	71.54	74.97	78.45
10,000	86.49	90.90	95.39	99.96	104.60
15,000	129.73	136.35	143.08	149.94	156.90
20,000	172.98	181.80	190.78	199.92	209.20
25,000	216.22	227.24	238.47	249.90	261.50
30,000	259.47	272.69	286.17	299.88	313.80

¹Indicates annual interest rate @ 30 years, 100% stabilized occupancy of 80 total units and a 1.30x debt service coverage ratio.

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Improvements to Common Areas

In a similar manner, Figure 2 provides us with a summary of what the individual cost increases or allocation for each resident's unit would be when substantial dollars are invested in *common areas* or the physical plant in general. The analysis is the same as the one for improvements in a typical *unit* with one big difference. In this case, we allocate or spread these new debt service costs across *all* of the total occupied units. For example, approximately 80 occupied living units in a typical 80-unit assisted living community (93% occupancy).

Figure 2 indicates that a \$200,000 investment in improving the public/common spaces, staff areas and "back of the house" resources of your senior living community will require each resident's monthly service fee to be increased by approximately \$25 per month or about \$0.84 per resident-day. That's less than a 1 percent increase. The *leverage* of investing in common spaces is very significant, because we are spreading the new debt service cost for common/public space improvements across *all* occupied units. That's a tremendous bang for the buck.

**FIGURE 2
COST RECOVERY FOR CAPITAL INVESTMENT IMPROVEMENTS TO
COMMON AREA/PHYSICAL PLANT**

Common Area/ Physical Plant Capital Improvement	Break-Even Increase in Resident's Monthly Service Fee to Cover Incremental Increase in Debt Service on Borrowed/Invested Funds to Pay for Improvement¹				
	7.0%	7.5%	8.0%	8.5%	9.0%
\$ 25,000	\$2.91	\$3.05	\$3.21	\$3.36	\$3.51
50,000	\$5.81	6.11	6.41	6.72	7.03
75,000	\$8.72	9.16	9.62	10.08	10.54
100,000	\$11.62	12.22	12.82	13.44	14.06
125,000	\$14.53	15.27	16.03	16.79	17.57
150,000	\$17.44	18.33	19.23	20.15	21.09
175,000	\$20.34	21.38	22.44	23.51	24.60
200,000	\$23.25	24.43	25.64	26.87	28.12
300,000	\$34.87	36.65	38.46	40.31	42.18
400,000	\$46.50	48.87	51.28	53.74	56.24
500,000	\$58.12	61.09	64.11	67.18	70.30

¹Indicates annual interest rate @ 30 years, 93% stabilized occupancy of 80 total units and a 1.30x debt service coverage ratio.

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Surprisingly, the cost recovery sensitivity for improving either assisted living or independent living is frequently favorable. In other words, you can invest significant amounts of capital and pass the cost recovery on to the residents in an effective, affordable manner – at least on an attrition basis as units are vacated due to resident turnover. Properly planned, incremental campus improvements may present *short-run* challenges, but they will result in substantial *long-run* benefits.

Call to Action

Using the approaches in this newsletter, determine how much you will have to raise fees in order to fund capital improvements of both assisted living units and common/public spaces. Next determine how much the value of your community will increase once capital improvements are made.

Finally, consider implementing an improvement plan in two phases:

1. **First, the common/public spaces** – This offers the biggest bang for the buck at a very nominal cost per resident.

Then . . .

2. **Upgrade the living units** – at least on an attrition basis as units turn over.

You may be pleasantly surprised at what you can accomplish.

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